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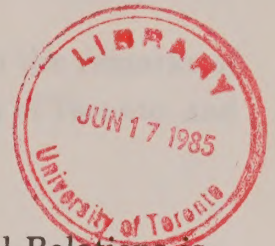
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OTTAWA & THE PROVINCES: THE DISTRIBUTION OF MONEY AND POWER

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(Toronto) – The latest study in a special series on Federal-Provincial Relations is being released today by the Ontario Economic Council. It foresees a tough set of negotiations between the two levels of government when they meet to discuss the forthcoming (1987) revisions to the country's federal-provincial fiscal arrangements.

This two-volume research report, *Ottawa and the Provinces: The Distribution of Money and Power*, is based on contributions made during a conference sponsored by the Council in Toronto.

In the opening address Professor Thomas Courchene of the University of Western Ontario, and the Council's chairman, stressed *the importance of broadening the agenda*. He suggested that through much of the postwar period, especially in the 1960s, a rapidly expanding economy permitted us to focus on techniques for extending public services. The mood of the times favoured sacrificing a little efficiency in order to achieve greater social equity. The essence of Professor Courchene's message is that the redesign of the fiscal arrangements must break with earlier patterns and find ways of distributing transfers more efficiently.

Conference participants agreed that the renegotiation of the fiscal arrangements must be conditioned by our recent experience of slow growth ('slowth'). Domestically, Canada is experiencing flat productivity growth and high unemployment; internationally, it faces an even more competitive and even hostile economic environment.

Participants seemed broadly sympathetic to the suggestion by Professor Courchene that decentralizing the federal system would improve and, in fact, might be a device for shrinking the public sector, as it encouraged the provinces to experiment with the private delivery of publicly funded services.

This report reflects the views of the authors and not necessarily those of the Ontario Economic Council. The Council establishes policy questions to be investigated and commissions research projects, but it does not influence the conclusions or recommendations of authors. The decision to sponsor publication of this study was based on its competence and relevance to public policy.



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Role of the federal government

This attracted differing views. The differences were crystallized in the remarks of Professor Al Johnson who teaches political science at the University of Toronto, and Claude Ryan, a member of the Quebec National Assembly.

Professor Johnson emphasized that any nation requires certain transcending values. For Canadians, he said, one of those values is the sharing, to some degree, of our wealth and income with one another; we must, as Canadians, be able to enjoy comparable services as we voyage across the land. For Professor Johnson, it is an axiom that the chief instrument for achieving this objective is and must remain the national government.

By contrast, Mr. Ryan affirmed that any national standards in the fields of social policy, health care, and postsecondary education 'should be governed by an agreement among the governments concerned' and that all shared-cost programs must allow for provincial opting-out with full financial compensation . . . the federal government should provide leadership of inspiration, encouragement, and support rather than leadership based on control and supervision'.

Conference participants looked at health care and the move towards national standards. Professor Leslie points out that the financial penalties the 1984 Canada Health Act threatens, create the potential for the federal imposition of national standards upon the provincial governments.

Rodney Dobell, President of the Institute for Research on Public Policy, summarized the act's enforcement procedures. They allow the federal cabinet to exercise wide discretion in the imposition of financial penalties on any province considered not to be living up to the enshrined principles of universality, accessibility, comprehensiveness, portability, and public administration.

Professor Leslie is inclined to think that the Supreme Court would invalidate any financial action that did try to impose program standards on a province.

Postsecondary education

David Cameron, the Assistant Undersecretary of State, in Education Support, Department of Secretary of State, in Ottawa, suggested that the federal government is likely to treat higher education as a matter of some priority. He noted a consensus among provincial governments about their obligations in postsecondary education is wearing thin.

This erosion is occurring at a time public opinion seems to be favouring higher education. Mr. Cameron says Ottawa is disposed to maintain and extend its participation, but, to 'spend smarter'.

Nevertheless, as Professor Leslie says, *the suggestion of national standards is there in the field of postsecondary education, and federal spokesmen have been showing increasing inclination to formulate specific national objectives, suggesting federal politicians and officials may be contemplating reintroducing conditionality in two senses: (1) making the size of the transfer depend on the content of educational programming; and (2) making the size of the transfer depend on the magnitude of provincial spending in the field.*

Income security

Michael Mendelson, Deputy Minister, Department of Community Services and Corrections, Government of Manitoba, proposed that the federal government withdraw from cost-sharing of provincial social-assistance programs and move directly into the area, making its own income-related payments, which could be topped up by any provincial government that desired to do so.

The difference between the present arrangement and the scheme proposed by Mr. Mendelson is that a basic federal program would establish minimum national standards or entitlements without requiring the provinces to make any contributions to implement them.

Equalization

No equalization formula can be so generous that it bankrupts the federal treasury. Consequently, the fiscal soundness of former, existing, and possible future equalization schemes received considerable attention from conference participants.

They also recognized that too generous a scheme, besides being fiscally irresponsible, would be politically unacceptable.

Two questions were implicitly put. The first was: to what degree do we have to compromise the principles of equalization to get a scheme that is financially and politically viable? And the second: can the formula be recast so as to achieve fuller implementation of the underlying principle without undue financial or political cost?

The geographic dispersion of political power

Robert Stanfield, former leader of the Progressive Conservative Party, now Chairman of the Board of the Institute for Research on Public Policy, spoke out his belief that the geographic concentration of political power is fundamentally wrong and must be reversed. Ottawa's economic powers are already too extensive, and they are usually exercised in a regionally discriminatory way. An unfettered federal spending power is incompatible with the division of powers, for the provinces have spending priorities that are as important as Ottawa's. Federal interference with provincial programs not only fosters inefficiency and irrationality in the delivery of public services, it is also illegitimate and must not be tolerated.

Professor Leslie states that national standards count. Diversity in techniques for achieving shared purposes or similar objectives is also an advantage, but it is a subordinate consideration. And he says *the distribution of money goes a long way towards determining the extent to which there will be national standards in public services.*

The major theme of the conference?

Douglas Hartle, Professor of Economics with the Institute for Policy Analysis of the University of Toronto, says it involves the probable impact of fiscal restraint on federal-provincial fiscal relations.

Professor Hartle suggests the possibility that federal-provincial fiscal relations are a factor contributing to the increasing sclerosis of Canada's economic system. The agreements, although they are not necessarily financed by taxing rents, can create rents that are understandably defended with great vigour and often at great cost.

He points out the overriding importance of the federal deficit. In negotiations with the provinces in 1987, the federal bargaining position is likely to be dominated by the 'necessity' of reducing the federal deficit. Whether such a stance is inappropriate or not, contrived or not, the provinces are in all probability going to be confronted with the federal government's insistence that its fiscal transfers to them be reduced. What is more, this federal demand for deficit reductions via reduced fiscal transfers will not only be accepted by the public but strongly supported as long overdue.

Professor Hartle explains that *the political costs of federal deficit reduction will be shifted, insofar as possible, to the provinces. In this situation, the fiscal 'negotiations' are bound to be extremely acrimonious, if not vicious.*

Professor Hartle points out that *compounding the problem will be protectionist measures undertaken by the provinces to give at least the appearance of trying to solve regional and local unemployment problems. He says these nontariff barriers damage the Canadian economic union, and the federal government will rightly oppose them.*

Hartle explains that the federal government's only ways of preventing them are through constitutional amendment or through persuading the provinces to adopt something like Tom Courchene's 'code of economic conduct'. But as Michel Robert, Commissioner of the Royal Commission on the Economic Union and Development Prospects for Canada, says, constitutional amendment is well-nigh impossible to get.

In his overview, Hartle says *for the most part, federal-provincial fiscal relations have been negotiated from federal strength and provincial weakness.*

'Since the federal government has often had the constitutional right to have its way or the fiscal means to bribe the provinces, many "agreements" have essentially been little more than unilateral declarations by Ottawa. Yet only Quebec and Alberta residents seem ready to provide public support for provincial "intransigence". The inclusion in the 1982 Constitution of the right to "reasonably comparable" equalization may provide the provinces with a much-needed fulcrum for leverage. By appealing to the courts (or threatening to do so), the provinces may have a bargaining counter that they can use in negotiating other aspects of fiscal relations.

In the likely fiscal climate of 1987, the appropriate adage would seem to be "any port in a storm".'

On health care, Professor Hartle says, *by including in the Canada Health Act penalties for provinces that permit extra billing by physicians, the federal government has put a straitjacket on the provinces*, restricting their scope for efficiency gains in medicare that could have been used to offset the costs of compensating losers in a time of expenditure stringency. Without efficiency gains, such compensation, if any, will just add to provincial costs.

Economics professors Frank Denton and Byron Spencer of McMaster University showed the conference that from a strictly demographic point of view, education is one field in which future savings on expenditure are possible. To expect them, however, would completely ignore the pressure that is bound to be forthcoming from teachers and other groups to enrich and expand the educational system so as to use up – or more than use up – these savings.

It seemed clear from Mr. Cameron's remarks that the federal government will soon have new proposals for expansion in some areas of postsecondary education.

Professor Courchene emphasized the desirability of working towards a '*code of economic conduct*' under which the provinces would agree to restraints against internal economic barriers.

But Professor Hartle says while such voluntary measures are obviously laudable in purpose, they also have an inherent weakness: those who cheat often obtain an advantage that is difficult to detect or punish. Nontariff barriers are complex and subtle. Who is to determine when the code has been breached? What sanctions would be imposed?

Political Science Professor Richard Simeon, a member of the Macdonald Commission suggests establishing *an internal arrangement like that of the General Agreement on Tariffs and Trade (GATT)*. Hartle sees this suggestion as promising and says the idea deserves further examination, at least as an alternative to a code of economic conduct. But he adds that GATT seems to have been largely ineffective in controlling nontariff barriers.

Professor Hartle concludes in his overview that there seems little doubt that in 1987 the spectre of slow growth, with concomitant demands for fiscal restraint and provincial protection, is likely to exacerbate the tensions that invariably surround federal-provincial fiscal negotiations.

'One cannot help but look upon increased federal intervention with extreme trepidation. There is also a legitimate fear that the provinces will increase their protectionist measures, further weakening the economic union, and that the federal government will be unable or unwilling to resist them.'

Michael Trebilcock, Professor with the Faculty of Law, University of Toronto, says in his overview comments that the present federal-provincial fiscal arrangements ignore and to a significant extent undermine economic efficiency.

He says if decision-makers maintain the present thrust of channelling federal funds towards earmarked areas of social expenditures and setting conditions within those areas, one can reasonably predict continuing and perhaps increased rancour and conflict between the federal and provincial governments over the division of the burden of financing shared-cost social programs.

'As the federal government presses to contain its deficit and limit its financial exposure under these programs, the provinces, which are facing reduced revenues and increased utilization of many of the programs because of the economic environment, do not take kindly to efforts to move more of the fiscal responsibility to them. This resistance is heightened by the provinces' feeling that Ottawa induced them to enter into some of these programs in more buoyant times and that it is now seeking to use federally determined program standards to constrain their efforts at cost-containment.'

William Watson, Professor of Economics at McGill University, made a persuasive case at the conference for *disentanglement in the health-care field*. Provided that the federal government yields tax room or provides cash grants to the provinces to allow them to continue, if they wish, their present levels of resource allocation to the field, efficiency considerations seem to favour allowing them to *experiment with alternative delivery systems*.

On postsecondary education, Trebilcock says it is not clear that a substantial federal presence can be economically justified in this field, any more than in elementary or secondary education, unless one accepts the argument that the development of specialized human capital can be most efficiently rationalized in terms of national labour markets, rather than regional ones. This consideration seems most relevant to advanced postgraduate study, high-level research, and adult training and retraining.

David Slater, Chairman of the Economic Council of Canada, told the conference, extrajurisdictional spillovers from research or adjustment may justify a federal role in these cases. However, Trebilcock says the federal government is already directly involved in all these areas, and he says there seems little justification for extending federal involvement into other areas of education policy.

Trebilcock says *although both federal and provincial governments provide substantial industrial assistance, co-ordination between levels of government is so weak that in many cases, these programs cancel each other out.* For example, some provide countervailing locational incentives. Some involve internal trade distortions, and, coupled with social programs, such as unemployment insurance and equalization payments, they entrench serious misallocations of resources.

'National tariff barriers have already created industrial structures that involve a high percentage of branch plants, small production runs, too many product lines produced primarily for the domestic market, and too little investment in research and development; the danger is that interprovincial trade barriers will exacerbate this tendency by fragmenting even the domestic market. Important recent work underscores the size and seriousness of present and potential losers to the Canadian economy caused by external and internal protectionism.'

The work referred to explains that in examining the economic performance of other major industrialized countries over the past several decades, analysts now generally agree that those that have performed most strongly (West Germany and Japan) are those that have adapted most quickly to change, be it technological, energy-related, or reflective of shifts in international comparative advantages. What also seems clear is that these countries have institutional characteristics that facilitate the concentration or integration of policies fostering rapid adjustment and addressing the distribution and mitigation of the costs of transition.

There are various suggestions for expanding and integrating other inputs into the process, including: parliamentary task forces; a permanently constituted council of industry and technology ministers and a reconceived Department of Industry, Trade and Commerce with a substantial capacity for policy development; a federal-provincial development commission; the upper house of Parliament reconstituted as a house of the provinces; reform of the electoral rules to enhance the breadth of support of the major federal political parties; and constitutional reform to constrain provincial and federal governments from creating internal barriers to trade.

A code of economic conduct

Both the federal and provincial governments should agree to *the regulation of various barriers to domestic trade* (procurement policies, tax policies, industrial subsidies, lack of pension or credential portability, and so on) *that are significantly at variance with national economic interests.*

The incentive for the provinces to agree to such codes would be the federal government's requirement of endorsement as a condition of receiving fiscal transfers under shared-cost programs or the equalization scheme. The *quid pro quo* for this increase of centralization in the economic sphere would, of course, be increased provincial autonomy in the social-policy sphere, achieved by Ottawa's withdrawal of most conditions pertaining to program standards.

General adjustment agreements

Professor Trebilcock believes another, probably much more pressing economic issue is *how to deal squarely with the need for and costs of rapid economic adjustment.* He says this is *probably the nation's central economic problem*, and it seems to him critically important that the federal government play a major role in confronting it. He says one possibility is to re-evaluate the general development agreements, which are mostly bilateral and cost-shared, and resuscitate them in the form of what might be more appropriately called general adjustment agreements.

Trebilcock believes areas in which government can play a significant role, if comparative experience is relevant, include the reorientation of training programs, retraining, severance payments, early-retirement schemes, wage vouchers,

relocation allowances, compensation for scrapping physical capacity, specialization agreements, and induced firm mergers and rationalizations. The central importance of and potential gains from intrasectoral adjustments to promote optimal economies of scale and specialization in existing industries suggest that facilitating such adjustments, especially in the manufacturing sectors, might be a major focus of general adjustment agreements.

Trebilcock says that in the long term, developing a more concerted and integrated view on the need for change, its directions, and the distribution of its transitional costs will almost certainly require reorientation of many of our fragmented institutional mechanisms in both public and private sectors.

He concludes that, clearly, the essentially territorial redistributive politics of past federal-provincial fiscal relations can no longer be expected to bear the full burden of collaborative decision-making in the face of the daunting economic challenges that now confront this nation. Thus, *both the agenda and the processes of fiscal decision-making in Canada require radical reconception.*

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Ottawa and the Provinces: The Distribution of Money and Power, Volumes 1 and 2, price \$17.00 is available at the following outlets:

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